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C O N F I D E N T I A L SECTION 01 OF 03 CAIRO 006703

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SUBJECT: THE NEW CABINET ONE YEAR LATER: REFORMS AND
REFORMERS ON THE MARCH

Classified by A/DCM Michael Corbin for reasons 1.4 (b) and
(d).

Summary

1. (C) One year after the cabinet shuffle that placed Ahmed Nazif and other economic reformers into significant ministerial positions, President Mubarak (and in the background, his son Gamal) have gained strength from the concrete results of the economic reform agenda. Overcoming skepticism from pundits and resistance from the "old guard," the new ministers enacted urgently needed reforms, balancing unpopular moves, like cutting subsidies on basic commodities, with more popular ones, like lowering tariffs on imports. The list of reforms is impressive, especially when compared to the anemic performance of every previous government. Investor confidence is up, GDP growth is expected to achieve five percent this year and the Nazif group will almost certainly be returned to the cabinet after the upcoming parliamentary elections. However, every major reform initiative requires the acquiescence of the powerful security and old guard voices in the cabinet (Defense, Interior, Intelligence, Foreign Affairs, and Parliamentary Affairs) and whether the new cabinet shifts the balance further in favor of the reformers is a question that looms large as elections begin. End summary.

Setting the Bar High: One Year to Get Results

2. (C) The success of the reformers over the past year surprised skeptics, and even some reformers, who questioned whether they could overcome resistance from the old guard and show tangible results before the 2005 presidential and parliamentary elections. The one-year deadline for results was set by the reformers themselves, but understood to also be the expectation of President Mubarak. The goal was ambitious, even audacious, given the years of economic problems the new cabinet inherited. One prominent businessman, a close friend and political ally of Anwar Sadat, noted that the reformers were not left with just the economic baggage of the previous government, but with problems 50 years in the making.

3. (C) Understanding that they had to win over not only the president, but also the public, the reformers moved quickly to enact urgently needed reforms designed to make the economy more market-based and globally oriented. Nazif and his cabinet allies understood that pain of the reform process would fall on the average Egyptian fast and hard, while the benefits would take longer to materialize. They therefore tried to balance unpopular moves, like cutting subsidies on basic commodities, with more popular moves, like lowering tariffs on imports.

The Reforms: Changing Laws, Changing Minds

4. (C) The list of reforms undertaken over the past year is long. Since the installation of the new economic reform cabinet, the GOE has:

- Developed and implemented an inflation-targeting monetary policy framework.
- Established an inter-bank foreign exchange market that helped end foreign currency shortages and virtually eliminate the black market for foreign currency.
- Signed and implemented an MOU with U.S. on financial sector reform, which includes privatizing one of the public banks, and addressing non-performing loans.
- Taken concrete steps to privatize the Bank of Alexandria (the smallest of the public banks) by the end of 2005 or early 2006.

- Sold shares in joint-venture banks such as National Societe General Bank and Egyptian Commercial Bank.
- Enforced new minimum capital requirements for banks and have set a goal of reducing the banking sector from 52 to 21 banks over a 3-5 year period.
- Cut subsidies on basic commodities including diesel (a 50% increase in the subsidized price), industrial natural gas (an almost 18% increase in the subsidized price) and water in Cairo (an almost 100% increase in subsidized price).
- Simplified the import tariff regime by reducing the number of tariff rates from 27 to 6. Decreased tariffs on a range of imports, which reduced the average weighted tariff from 14.6% to 9.1% and moved Egypt from 75th to 30th place on the World Bank's ranking of countries with the lowest tariffs.
- Passed a new income tax law which cut personal income tax rate from 32% to 20%, standardized deductions for all taxpayers, and created a flat corporate tax rate of 20% (reduced from an average rate of 40%).
- Set up a "one stop shop" for foreign investors starting businesses in Egypt.
- Published the GOE budget using IMF-approved accounting standards to provide greater transparency.
- Privatized 19 public companies, including enterprises the previous government had deemed "strategic" and thus ineligible for privatization. Plans are underway to privatize Eastern Tobacco Company and sell shares of Telecom Egypt on the New York Stock Exchange.
- Broadened commercial relations with Israel by concluding with its neighbor the Qualifying Industrial Zones agreement and a gas export agreement.
- Resolved long-standing trade and business issues of U.S. companies, including eliminating excessive sales taxes on soft drinks and removing restrictions on the import of U.S. beef products.

15. (C) In addition to these concrete steps, the reform ministers have pushed hard on changing the mindset of government officials and bureaucrats. They have promoted government decentralization, by undertaking efforts to move some decision-making and control over budgetary resources from the central government to the local level. They have tried, with mixed success, to overcome resistance within their own bureaucracies, which are chock-full of surplus workers who see reforms as a threat to their jobs and authority.

----- Tangible Results and New Momentum -----

16. (C) Under any assessment, the breadth and depth of reforms accomplished in just one year would be an achievement. But when judged against the anemic record of the previous governments, and recognizing the resistance put up by the old guard in the NDP and fearful bureaucrats in their own ministries, the reformers record is rather astounding. GDP growth, which hovered around 3.2 percent from 2000-03 and only reached 4.3 percent last year, is expected to hit 5 percent in 2005. Proceeds from privatization of public enterprises has generated \$500 million over the past year, as compared to only \$14 million over the previous 16 months. The Cairo and Alexandria Stock Exchange is the best performing stock exchange in the world among emerging markets. The Egyptian pound has stabilized against the dollar and would likely appreciate if not for suspected Central Bank intervention to keep the pound stable.

17. (C) The best indication of the reformers' success, however, may lie less in the numbers than in a change in perception. Few may remember now that when the cabinet shuffle was announced a year ago, speculation was rife that the reformers would not be able to deliver. Rumors were circulating that the old guard was setting up the reformers to take the fall for not resolving the economic problems that their stability-promoting policies had in fact precipitated. Failure seemed more likely than success, as every major initiative had to pass "the old guard test," and some reforms, like eliminating major subsidies, were completely off-limits from the start. Field Marshall Tantawi openly resisted many of the reforms, and he found plenty of support in the cabinet parliament from those who saw reform as a threat to their political and personal interests.

18. (C) One year later, however, perceptions have changed. As a result of the reforms, the business climate has

noticeably improved and investor confidence is surging. Local businessmen have remarked on streamlined customs procedures and greater responsiveness from ministries in addressing their business concerns. A lawyer at one of Egypt's premiere law firms noted a dramatic increase in the number of inquiries from foreigners interested in setting up operations in Egypt. As for the public, which the old guard predicted would react strenuously to disruption brought about by reforms, the reaction has been decidedly low-key. Though facing higher prices and economic uncertainty, the public seems grudgingly resigned to accept the immediate pain for the promise of change.

19. (C) The reformers have been strengthened by their success and will almost certainly be returned to office following the upcoming elections. The looming question, however, is whether President Mubarak will add to their number. Rumors abound that the President will appoint new ministers after the parliamentary elections. The betting is that the powerful defense and security ministers will remain in the cabinet, with the exception of Minister of Interior El Adly, the final casualty of the Sharm bombings. Even then, however, no one expects anyone other than a trusted, like-minded ally of the President to take El Adly's place. With less than a third of the cabinet considered reformist or reform-friendly, there is ample opportunity among the remaining dozen or so portfolios to increase the reformers presence and power in the cabinet. The decision, however, rests with Mubarak, who has been touting the desirability and value of reform in his recent election appearances, but will balance the push for reform with his perennial concerns over security and stability.

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